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Who Ought to Pay the South Dakota Tax Bill?

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"My taxes are too high!" This is the recent battle cry for many taxpayers. We demand that other people pay their "fair share" and we get angry when we believe that we are personally paying too much of the "tax burden." As a result, we seek and are often promised "true tax reform" that will create a more "equitable" tax system.

Unfortunately almost everyone believes that they are paying more than their fair share of the tax burden. As a result, there is no such thing as a universally fair and equitable tax system or a true tax reform proposal because what is fair to one group or individual is almost always held to be unfair by another.

Then what is our tax problem in South Dakota? Although the proposed solutions were different back in the 1890's, the two-fold tax problem that was facing our first state legislature is the same set of tax decisions that face our current state legislature: (1) How much revenue ought to be raised? and (2) What should the mix of taxes be? This newsletter outlines some basic principles of taxation and provides factual information concerning the tax problem and the probable consequences of the alternative solutions available.

How Much Revenue Ought to Be Raised?

Some people ask: "Why must we pay any taxes at all?" Well, our state and federal constitutions say that government has the responsibility to provide for the common defense and to promote the general welfare of the people. The public has also demanded public services such as highways, schools, police, and fire protection because the perceived needs would simply not have been met if we relied upon a market to supply them. So, taxes collectively provide such functions in a more efficient manner than individuals could have provided.

On the other hand, in a market oriented economy, we get concerned if the government taxes away too much of our income because we individually would like to decide how to spend our personal income rather than turn too much of that spending authority over to Uncle Sam. As a result, there has been and always will be debate over what government ought to finance for the people and what the people should pay for individually.

What level of government finance do we have now? South Dakotans' paid an average of 10.6% of our personal income in state and local taxes in 1980. People in 32 other states had larger tax bites for state and local government. In 1960, our parents paid 11.1% of their personal income. Ten years ago, we paid 13.3%. So, state and local taxes are currently higher in a majority of other states and they have been higher in South Dakota in the past. This does not imply that we should or should not raise taxes. It is simply a statement of fact.

Where are we headed? Current spending cuts, tax cuts, and block grant proposals indicate that the flow of revenue from the Federal government to South Dakota is likely to be pared down. Federal sources account for 29% of South Dakota state and local government general revenues. So any change in federal funding levels will significantly affect state and local government. Second, the costs of providing many state and local services have continued to increase and tax revenues are more uncertain than normal because of the current state of the economy. These trends indicate that South Dakota taxpayers and their state and local leaders will likely be faced with some tough public decisions in the next few years. If present trends continue, we will be faced with reducing government program expenditures, increasing tax revenues, or a combination of both.

What Should the Tax Mix Be?

Regardless of the level of taxation, we must still decide how much revenue ought to come from each tax. Therefore, the remainder of this newsletter focuses on the tax mix problem. If we look at our total U.S. tax bill including Federal taxes, approximately 64% are income taxes; 19% are from sales, use, and excise; 12% come from property; and 5% come from other taxes. Now, South Dakotans' pay about 55% of our tax dollar in the form of income taxes because we are one of 5 states with no state personal or corporate income tax.

What alternatives might be considered if we decide to overhaul the tax structure in South Dakota? Looking at our state and local taxes, we find 45% come from property, 30% from general sales and use, 12% from motor fuels and vehicle licenses, and 13% from all other taxes. If we desire to "overhaul" the tax system instead of having a "tune up", there are only three sources available that produce enough revenue: property, sales, and income. If, for example, we want to change taxes 5% to 10% in a tax system that generates over 500 million in revenue, we are talking about a change of 25 to 50 million dollars. "Sin" taxes---such as liquor, tobacco, and gambling---are generally not capable of producing this kind of revenue. Liquor and tobacco bring in about 10 million each. Gambling might be in the same ball park. This again does not mean that we should or should not levy these taxes. It does mean that these taxes can only be used to "tune" the system up because they are incapable of producing enough revenue for an overhaul.

What Are the Options?

Any major tax decision will require a choice among four basic ways to finance state and local government. These options are: (1) continue the current tax mix, (2) place more emphasis on sales and less on property taxes, (3) place more emphasis on property and less on sales, and (4) implement an income tax and place less emphasis on sales and/or property. (Motor fuels and vehicle licenses are earmarked for roads and highways and therefore are not included as a general government tax option.)

The first option is to continue the current state and local tax mix. As a percent of personal income, South Dakota ranks 10th in property taxes, 13th in state and local sales taxes, 5th in motor fuel and vehicle license tax revenues and 46th in income taxes. (We collect a bank franchise tax that is based on net income which accounts for the rank of 46th instead of lower.) As a result, the tax mix in South Dakota places higher emphasis on sales and property taxes, and less emphasis on income than is true for most states.

The second alternative is to place more emphasis on sales and less emphasis on property. This could be done either on a state or local level. For example, an additional 3/4¢ increase in the state sales tax would raise about $27 million which is roughly 10% of property taxes collected in South Dakota. However, this statewide approach to replacing property taxes requires that we decide how to distribute state revenues to local units of government. This often is not an easy task because perceived revenue needs of some communities always exceed the revenues generated by a distribution formula.

Alternatively, if the sales tax is imposed by municipalities or by counties, substantial property tax relief would not necessarily result. Large volumes of sales in urban trade areas generate considerable tax revenues whereas rural areas are characterized by smaller sales volume. In Minnehaha and Pennington counties, for example, a 1/2¢ additional sales tax would generate enough revenue to reduce property taxes by 10% without changing total revenue available to run all local government units county-wide. Faulk and Harding counties, on the other hand, would have to impose a 2.5¢ additional sales tax to reduce property taxes by

10% (assuming volume of sales remained constant).

Who pays the sales tax? Anyone who buys a consumption item within the tax jurisdiction--regardless of where they reside--will pay the sales tax. However, in the final analysis, the consumer is not always the one who pays. For example, a one cent city sales tax on a $50,000 tractor is a $500 difference in price due to the tax. Often times a farm machinery dealer and those who sell big ticket items are forced to absorb some of the local sales tax in order to prevent customers from going to a competitor a few miles away outside of the tax jurisdiction. So under some conditions, businesses are forced to pay some of the sales tax. (This doesn't apply to automobile dealers in South Dakota because they are exempt from the local sales tax.)

<u>The third alternative is to place more emphasis on the property tax and less emphasis on the sales tax.</u> In this case the revenue substitution ratios are reversed. For example, a 10% increase in the property tax state-wide would produce about 27 million and could be used to lower the sales tax by 3/4¢. Property taxes could be raised in various ways. We could raise full and true value on the tax rolls to the actual market value of property. We could simply mandate that county commissioners raise their taxable percentage of full and true valuation. We could raise the mill levy limits imposed by the legislature on local units of government. Or, we could simply impose a state-wide property tax levy.

Who pays the property tax bill? In South Dakota, 58% of property taxes are paid on non-agricultural real property, 35% are paid on agricultural land, lots, and agricultural non-residence improvements, and 6% are paid on state assessed utilities. Under some conditions, property taxes can be passed forward to the consumer. For example, in a college town where the need for apartments often exceeds the number available, landlords are able to pass a property tax increase on to the renter as higher rent. However, under other market conditions businesses must absorb the tax. In a state with relatively high property taxes, farmers cannot pass all of a property tax increase on to the consumer because they must compete with farmers in other states.

Taxes on South Dakota farm real estate in 1979 were $.83 per $100 of full market value. The states adjoining South Dakota averaged $.61 per $100 of full value, and the U.S. averaged $.60 per $100 of full market value for farm real estate. Of the adjoining states, only Nebraska had a higher tax rate. Consequently agricultural landowners in South Dakota are not likely to pass much of a property tax increase on to consumers.

<u>The fourth option is to implement an income tax and place less emphasis on sales and/or property taxes.</u> Again, the income tax could be imposed state-wide or imposed on a combination state and local basis. (Other states with local option income taxes collect the local tax in conjunction with a state income tax.) On a state-wide basis, if we imposed a personal and corporate income tax using an average rate of 0.7% of our federal taxable income, we would raise $27 million that could replace 10% of the property tax or lower the sales tax by 3/4¢. Raising this amount with a personal income tax alone would require a rate of 0.9%. A corporate income tax alone would require an approximate 2.7% rate to raise $27 million.

Who pays the income tax? All corporations and individuals who earn taxable income within South Dakota would be subject to the income tax, regardless of where they reside. Initially, individuals would likely account for 75% and corporations 25% of total state income tax collections under uniform tax rates. If income taxes are used to partially replace sales and/or property taxes, then part of the tax collections will tend to be shifted to individuals and corporations in higher income brackets, particularly to those who also possess relatively little property and/or pay relatively little sales tax as a percent of income. On the other hand, tax collections would be shifted away from lower income taxpayers, particularly those who possess a lot of property and/or those who currently pay a relatively high sales tax as a proportion of income. Although it doesn't hold in every individual case, it can be said in general that this

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shift to higher income bracket taxpayers would occur as long as the income tax is less regressive than the sales or property tax that is replaced.

This bracket shift also means that some of the tax is shifted to the federal government. A state and local tax hike of $1.00, for example, will only increase the total tax liability of a taxpayer in the 40% federal income tax bracket by 60¢. This results because the additional state and local tax is deductible on the federal income tax return and thus lowers the Federal income tax liability by 40¢. Now, if a state income tax is used to replace part of the property or sales tax (which are also deductible), some of the tax change would likely be absorbed by the federal government because the deductions would be shifted to individauls and corporations in higher income tax brackets where the deductions are worth more in terms of reduction in federal income tax liability.

Finally, businesses--corporate or otherwise--have the additional flexibility under some market conditions to pass part of a net increase in taxes on to consumers or backward to the factors of production. For example, a South Dakota firm that simultaneously faces a tight supply in its raw material markets and a weak demand in its product markets, will likely be forced to absorb most of a tax increase. However, when these conditions do not hold, part of a business tax increase is likely to be passed on rather than being completely absorbed by the firm as reduced profit incentive. If part of a business tax increase is passed on through the firm's transactions, then the passed on portion of a tax hike is paid by the respective consumers and/ or raw material suppliers regardless of their place of residence.

Concluding Comment

In the final analysis, the tax policy adopted will be a compromise between economic reality and what is socially acceptable by South Dakotans. People will determine what is socially acceptable by applying their values to the facts and myths that are associated with the tax problem and the options available. So, the public's understanding of the facts is the key to the political process. This newsletter presents some of the basic economic facts about our tax options. Personal values have been left out as much as humanly possible. This has been done to allow the reader to decide what the best solution is for solving the South Dakota tax problem.

For additional information on this subject contact the author for details about a soon-to-be-released Extension publication titled "Financing State and Local Government in South Dakota."